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Half Year Results 2017

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Alison Cooper – *Chief Executive*

Good morning and welcome to our 2017 half year results presentation.

This morning I'm joined by Oliver Tant, Chief Financial Officer and Matthew Phillips, our Chief Development Officer… and in the audience is Dominic Brisby who runs our Returns Markets and Amal Pramanik, our Growth Markets.

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Summary

We've had a good start to the year as we continue to deliver against our strategy, supported by additional investment behind the right brands in the right markets to drive further quality growth.

This performance is underpinned by the rollout of our Market Repeatable Model, which is providing an effective and consistent approach for delivering sustainable growth in markets.

Our investment programme is on track and is delivering improved share trends in our priority markets, with share gains in our Growth Brands.

Our cash conversion remains strong and we are delivering another year of 10% dividend growth, making this the ninth consecutive year.

Given the significant impact the step up of investment has on these half year results, I will focus this morning on how the additional investment is driving the improvements in brand and market performances…

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Delivering on our Priorities in FY17 – *Track record of consistent delivery*

We are delivering against our priorities for 2017, focused on four areas….

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We again improved the quality of revenue as our Growth Brands continued to outperform the market with volume and share growth. We further simplified the portfolio through our successful brand migration programme and our Growth & Specialist Brands now represent more than 60% of net revenues. We also continued to invest in building the brand equity of blu and in the technology to support our next generation product launches.

Across our footprint we increased investment in our priority markets… and we have rolled out our Market Repeatable Model, aligned with our investment programme. We have delivered share gains or improving share trends in many of our priority markets, with our Growth Brands gaining share across all of our divisions.

Our cost optimisation programme is now expected to save £130m this year, ahead of the £90m we announced previously. We have continued to refine our operating model and simplify our ways of working, creating a stronger, more agile business.

And our disciplined approach to capital management has delivered another strong year of cash conversion at almost 100% with a £1.2bn reduction in net debt at constant currencies.

So, further delivery against our strategic priorities in the first half, with an even sharper focus on the brands and markets that deliver sustainable quality growth and generate further shareholder returns.

I'll now hand over to Oliver who will take you through the half year results headlines.

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Oliver Tant

Thank you and good morning everyone.

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Summary Financials ***– Investing in quality growth***

This has been a half year of significant investment… deliberately focused on our Growth and Specialist Brands in markets that offer the greatest opportunities, supporting the next decade of value creation for shareholders.

As expected, the additional investment has impacted the half year's constant currency revenue and profit numbers.

Our footprint exposure to developed markets has supported a 14% currency translation benefit to our net revenue, operating profit and earnings.

As Alison mentioned, we achieved another strong cash performance with working capital improvements supporting an annualised cash conversion of almost 100%, such that we delivered free cash-flow after dividends of almost £1.2bn.

Over the last few years we have consistently generated around a billion a year or more of available cash-flow, which we have used to repay debt and strengthen our balance sheet.

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Volume Performance ***– Industry decline driving H1 volumes***

Volumes for the period were 126.3bn sticks, down 5.7%, driven primarily by industry volume declines of 4.3%, representing about three quarters of the decline. Industry volumes have declined following a strong comparator period and further regulatory changes and excise increases. The remainder of our volume loss has been in our Portfolio Brands – and partly as a result of our focus on markets that deliver quality volume.

It also reflects a continued focus on very clear footprint investment choices – pursuing quality volume but not chasing share for share's sake. The economics and profitability of some geographies continues to influence our investment decisions in markets such as Azerbaijan.

We continue to focus on driving quality revenue growth by simplifying the portfolio and investing in our strongest brand equities, such that our Growth Brands are significantly outperforming market trends, with volumes up 3.2% and share up 60 basis points.

Our Specialist Brand volumes were down slightly as we migrated Route 66 into our Growth Brands. The Portfolio Brands are made up of many, relatively small local brands which we are migrating into Growth Brands or delisting. The share of these brands declined 90 basis points – giving an aggregate share decline of 30 basis points.

Our Growth Brands have consistently outperformed in recent years with volume and share growth ahead of the market – reinforcing the importance of our consumer migration programme to our quality growth agenda. The more we can convert consumers from our Portfolio Brands to our Growth Brands, the more quality growth we will deliver… as well as the efficiencies that we generate from the complexity reduction.

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HY17 Net Revenue – *Pricing reflects phasing and investment*

Revenue was affected firstly by volume declines as we have already seen.

Price mix is broadly flat in line with our year end guidance. This has been driven by firstly, the phasing of price increases in the past year, you will recall that price was weaker in the second half of last year. Secondly, the additional price investment we have made in the period and finally, the termination of the PMI distribution contract in the UK and Morocco.

Gains of 14.8% in FX translation mean that we delivered a 9.3% total increase in net revenues in the period.

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HY17 EPS Growth – *Expected HY decline driven by investment timing*

At constant currencies EPS was down by 5.9% as a result of the additional £160m of investment we made in the period.

Our investment is on track against the £300m we announced in November. There is a bias to the first half, while we expect the associated returns and cost optimisation savings to be biased to the second half.

Earnings also benefited from positive contributions from interest, tax, and minorities.

Adjusted EPS for the half year was up 7.9% at actual rates, supported by 15.6 pence of translation FX benefits from the weaker sterling.

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Divisional Performance *– Investments driving quality growth and share*

Net revenues and margins in our divisions have been affected by our investment in price, A&P and overheads and therefore show negative trends over last year as we expected. The impact from the additional investment was about 430 basis points on our Group margins.

In the US, our margins improved 420 basis points, despite the increased investment because of ongoing cost efficiencies and a one-off pension curtailment gain following the closure of a US defined benefit pension plan.

The quality of our revenues continues to improve as we generate an increasing proportion from our Growth Brands and Specialist Brands, supported by the successful migrations and strong brand performances.

Our portfolio simplification and investment focus has also delivered Growth Brand share gains across all of our divisions.

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More Cost Optimisation *– [Accelerated savings in FY17]*

On cost optimisation… we have made excellent progress.

We delivered £60m of savings in the first half and, as Alison said, we now expect to deliver £130m of savings versus the £90m we originally announced… although our overall expectations of £300m for each of the two phases remain unchanged.

This will bring cumulative savings from both phases to £370m by the end of FY17, in line with our plans.

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Capital Discipline *– Strong cash conversion; 90% expected for FY*

Our cash conversion rate over the 12 months to March was nearly 100%. It has been achieved by a strong working capital performance, boosted by the recognition of an additional three months of the Master Settlement Agreement creditor relating to the US business, and an unwind of the stock build to manage the EUTPD transition.

Even after stripping these benefits out, we delivered improvements across our key levers by better management of payables and receivables and by optimising our supply chain and stock holdings.

Our focus on cash continues to be high and as result, we remain very well placed to deliver our cash conversion target of around 90% for the full year.

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Foreign Exchange – *Strong currency translation benefit in FY17*

Foreign exchange translation provided around a 14% benefit to actual revenues profits and earnings, driven primarily by the weaker pound against the US dollar, the euro and the Australian dollar.

The recent volatility in currencies is likely to continue – particularly with the impact of the UK election and Brexit on sterling – which makes it difficult to provide guidance for the rest of the year.

Based on rates at the end of April, we estimate translation will add around 9% to our full year earnings if current spot rates persist, although we expect FX markets to remain highly volatile.

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Strengthening Balance Sheet – *£1.2bn reduction at constant currency*

Our annualised operating cash performance remains very strong, delivering £1.2 billion of free cash-flow after dividend in the 12 month period – this is before we take into account the £1.4bn of currency translation and fair value changes on our derivative portfolio.

The denomination of our closing adjusted net debt was 61% in EUR and 39% in US dollars – materially matching the currency split of our profit streams. The recent weakness in sterling has caused an adverse translation effect on our debt over the last 12 months of around £1.4 billion.

We are taking the opportunity to repay facilities and refinance where appropriate. In January 2017 we issued two bonds, for 1bn euro with fixed coupons averaging less than 1%. We also repaid the remaining portions of our bank acquisition facilities, meaning that all debt is now repaid or termed out in the capital markets.

The headroom created by our strong cash-flows ensures that we do not have any further financing requirements in the medium term.

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FY17 Outlook – *Quality growth in brands and markets that matter*

In summary, these results are further evidence of continued delivery against our strategy.

Looking to the full year, our investment plans are supporting improving share trends in the brands and markets that matter. We expect these trends to continue, resulting in a stronger second half –despite a further deterioration in industry volumes, combined with competitive pricing in several geographies.

We expect constant currency earnings to be in line with expectations as we deliver on our investment initiatives and generate further cost optimisation benefits. Our view on full year tax rate, capex, etc. are unchanged and our provided in the appendices.

Our focus on capital discipline and our strong balance sheet supports our strategic agenda as well as growing returns for shareholders and debt repayment.

Thank you. I will now hand you back to Alison….

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Alison Cooper – ***Chief Executive***

Thank you. Oliver

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Our Strategy

We have increased investment behind our strategy…. behind our strongest brand equities and priority markets, supporting our quality growth agenda.

I'll now update you on our ongoing portfolio transformation and provide examples of how our increased investment is delivering improved share trends… consistent with our first two strategic priorities as shown here.

Central to our portfolio and footprint development is our investment allocation and how we apply our Market Repeatable Model to deliver sustainable quality share growth.

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How to Win in Market – ***Market Repeatable Model***

Those of you who have listened to our webinar in March know that this is our refined "go to market" approach that is central to our growth ambitions across our brand and product portfolio, both in tobacco and related adjacencies.

As part of our review last year, we affirmed the capabilities that enable us to win in market, based on our experiences, successes and learnings in markets such as Australia. These were refined and codified into our MRM, providing a simple, effective and consistent operating framework and building on the sales growth drivers we were already using in the business.

There are six elements to our MRM and we believe that to win in market all six need to be holistically applied… And the sixth element is a requirement to learn from what is going well and what's not, supported by KPIs to enable monitoring and improvement around the MRM wheel.

I will use this MRM framework to take you through some of our investment choices, which are supporting improved brand and market performances.

I will start with strengthening our portfolio….

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Strengthen Portfolio – *More radical simplification*

We have continued to transform our portfolio through our focus on fewer, bigger, stronger brands – adding to our quality and sustainability of growth as we drive more of our revenue from our strongest brand equities.

Our Growth Brands have continued to outperform on volume and share, supported by our successful brand migration programme. We have now completed 65 migrations, with an average consumer retention rate of around 95%.

Migrations will continue to be part of our portfolio simplification agenda over the next few years. However, we are now more radically cutting SKUs in markets, taking out low relevance SKUs to increase the focus on our bestselling SKUs – our optimal portfolio. We've already achieved a 33% net reduction in SKUs since 2013 – and we believe there is still more to come beyond our original 50% target, whilst we focus growing the optimal portfolio.

Successful regional trials in Russia and France, with a 50% reduction in SKUs have now been extended nationally and we are rolling this out across other markets including Italy, Germany, Spain and Australia.

Retailers have welcomed the simpler portfolio and the working capital benefits of higher stock turns. It provides better availability for consumers and for Imperial it stimulates improved revenue growth, while the portfolio simplification supports further product cost efficiencies.

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Strengthen Portfolio: Migrations: *More simplification, focus and quality*

As a result, we have consistently grown the market share of our Growth Brands and a growing proportion of our revenue is from our Growth and Specialist Brands (our Asset Brands), reducing the drag from our tail of Portfolio Brands.

The agenda continues to be about quality share in our strongest equities… and as the proportion of our sales generated by our strongest equities grows, the portfolio drag reduces, resulting in more growth.

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Strengthen Portfolio – *Parker & Simpson: Building new Growth Brands*

Although our focus has been on reducing the number of brands in our portfolio, we've shown how we can develop and grow a new brand if needed.

Since launching in 2012, we have established Parker & Simpson as a key Growth Brand that now accounts for over 5% of our total tobacco volume.

Building on our strength in value but with premium cues, Parker and Simpson has enabled us to build a consistent international value for money offering across multiple markets.

We developed Parker and Simpson with a distinctly British heritage, relevant particularly in Eastern Europe where consumer demand for international brands continues to grow.

We have built scale initially through a series of migrations in over 10 markets and it now has a material share through strong retail engagement and ongoing reinforcement with consumer relevant portfolio initiatives and activations.

Applying the MRM in-market has supported the ongoing development of the brand and we believe it has considerable future growth potential.

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Developing Consumer Experiences – *blu: investing in brand and technology*

We are also using our MRM in our e-vapour business.

Our simple market-focused portfolio is centred on blu, a high quality e-vapour brand with a targeted range of products.

Brand investment has continued to support high equity scores on metrics such as awareness, quality and satisfaction, demonstrating that it's a brand with strong equity that resonates well with consumers – building emotional connection in a largely functional category.

From a technology perspective, our second generation product, blu PLUS+ performs very well, achieving high consumer loyalty. And we are continuing to develop our next generation offerings to provide improved consumer experiences… for example, consumer trials continue ahead of a European launch of our third generation technology later this year.

We have applied a consistent premium pricing strategy – avoiding the discounting that has become more common with weaker brands and technologies.

We're investing in distribution in the largest e-vapour markets while evaluating new market opportunities. Our customer engagement activities are focused on retailer education, building awareness and seeking opportunities in key accounts.

Next generation products present an exciting opportunity, with the most significant development and optionality in e-vapour… our MRM will enable us to maximise these e-vapour growth opportunities and we believe it can also be successfully applied across other consumer adjacencies.

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Develop Footprint: USA – *Investing to build equity in asset brands*

Let's now focus on some of our priority investment markets and how our increased investment behind MRM is working.

In each of these markets, we apply all elements of the MRM wheel but today I will highlight those areas where we have particularly focused our investment.

So first up is the US, where we have been investing in brand equity, a consistent pricing strategy through optimised buydowns and improved distribution through our 169,000 retailer agreements…

In the US, our portfolio priorities are Winston & Kool. We revamped the Winston pack towards the end of last year and this has been followed by the relaunch of Winston Gold and consumer activations including a new media campaign. These are extending the brand appeal to a broader consumer base and starting to address the demographic weakness of the brand.

The repositioning of Kool is also being supported by new point of sale, web presence and direct mail initiatives.

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Develop Footprint: USA – *Positive trajectory in cigarette share continuing*

And the positive trajectory of our focus premium brands – Winston and Kool – is continuing with further share progress. The apparent recent decline in March is caused by the timing of sales to retail, while over the same period, the consumer offtake data indicates continued share momentum.

Consistent with our portfolio strategy, we are aligning behind our strongest equities, resulting in some declines in our Portfolio Brands. However, a weaker discount segment has meant that Maverick and USA Gold are also under pressure so we are taking action to further support Maverick in particular to address the current decline.

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Develop Footprint: USA – *Consumer led approach driving MMC share*

I am also really pleased with the performance of our mass market cigar business where our investment in a focused portfolio is growing market share.

We completely changed our route to market last year – moving from distribution push model to consumer pull.

At the same time we focused our investment behind our best cigar brands Backwoods, Dutch and Phillies – driving increased visibility though point of sale, consumer activation events and digital marketing.

This has delivered an increase in year to date share of over 100 basis points, with growth in our main focus brands Dutch and Backwoods in particular, well ahead of the market – plus improved sales and profit. A great result.

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Develop Footprint: UK – Growing share in a challenging market

Turning now to the UK where you will recall that I said 2017 would be a year of challenge and churn, given the introduction of EUTPD and plain packaging in a very competitive environment.

A challenging market presents risks to manage but also opportunities... and we have invested behind our MRM and grown quality share.

We have optimised all elements of our MRM to drive this success.

We have an increasingly focused optimal portfolio, which we have selectively added to, to help consumers navigate the EUTPD changes. The launch of the L&B "double bundle" is a good example: it contains two bundles of 10 cigarettes to help consumers control their consumption as the market transitions from 10s packs.

Being always on price strategy has been critical to our success and this will be helped by the introduction of a minimum excise tax.

From a distribution and customer engagement perspective we have also upweighted our spend, helping retailers through the transition, adding to our market coverage and further empowering our reps with better information & CRM tools.

All resulting in extra listings, increased share in key accounts... the fastest growing brand in Players and overall year to date share growth – in a year of considerable churn.

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Develop Footprint: Germany – Growth in FCT supporting improved share trends

Germany has been a slightly weaker market than anticipated this year, with a stronger initial reaction from consumers to the new EUTPD packs. But this continues to be a growing and significant profit pool where we have added to our investment.

We already have a focused portfolio with strong equities and are investing behind additional portfolio, equity & activation initiatives, including JPS Bluestream and the successful Gauloises campaign. Our cigarette share is on an improving trend and will be further supported in H2. And in fine cut, new JPS Formats and increased activation on West have resulted in a spot share improvement of almost 200 basis points…

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Develop Footprint: Russia – Driving performance in growth segments

Russia was one of the pilot markets for more radical SKU reduction and this has now been extended nationally - with a 66% reduction in SKUs- to achieve a much simpler optimal portfolio, which has resulted in improved availability.

We have increased investment behind Parker & Simpson following the Balkan Star migration and its share continues to grow in a very competitive segment - where ensuring we are on price strategy has also required additional investment.

Availability has also been increased through investment in more sales reps and key account relationships, all adding to an improved share trajectory - not yet growing but we have already achieved stability.

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Develop Footprint: Italy, Saudi, France and Australia - Distribution and customer focus

And a few more markets benefiting from additional MRM investment…

In Italy our share is up 80bps, reaching close to 5% share of market due to investment behind visibility & activation with JPS, which achieved a record share in the first half… we have also extended the distribution of Davidoff to more cities, adding to our share… and both brands are benefitting from our early success from investment in the patentini horeca channel.

In Saudi Arabia, our increased consumer activation behind West has taken its share to almost 6%. Recent investments in new formats, such as Fresh Box and Absolute, have helped to stabilise Davidoff's share in the declining premium segment. Overall share is up around

250bps over the past 18 months. Currently, we are assessing the implications of a potential duty increase with relevant portfolio and MRM responses.

In France, share trends are also improving, with News growing in both cigarettes and fine cut – now a 9% brand since the migration of Fortuna… although our overall share is not yet in growth. The market is undergoing significant changes with plain packaging & various additional taxes – and so again our MRM focus is key. The successful completion of our SKU rationalisation programme has reduced the portfolio by over 60% - providing a much simpler, focused assortment to compete in a plain pack environment. We are investing behind the brands and our price strategy, whilst planning additional distribution investment for the second half to further support quality share development.

In Australia, we have not had to do much more investment, as Australia was one of the key learning markets that we used to refine the MRM in the first instance… here MRM continues to work successfully… JPS continues to perform strongly as the market leading brand and our recent launch of fresh seal RYO is improving our fine cut share. We are also investing in key accounts & CRM technology further improving our customer relationships… and have continued to grow share.

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Investment Driving Quality Share Growth – Encouraging early signs in priority markets

To give you a broader feel, the share momentum across a larger number of markets is shown here – and you can also test your flag spotting skills!

The green arrows show markets that are growing share in the 6 months year to date or where the year to date trend has improved compared the 12 month MAT performance.

We are showing a range of markets here… not all of them are priority investment markets… but in all of them we are focusing on MRM and there are encouraging trends developing in the markets that matter.

So, there is a lot that is going well but inevitably there are also things that don't always go to plan and we are capturing those learnings.

For example, learnings around managing stock changes in markets whether during SKU rationalisation or regulatory change; learnings about product availability and learnings around how we further enhance our retail relationships.

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Our Priorities for FY17 – *On track to deliver*

So to conclude… We are investing more behind the right brands in the right markets to deliver quality growth and returns. Our Market Repeatable Model provides a clear framework for our investment and is driving improved Growth Brand performance and improved market share trends in priority markets.

We will continue to strengthen our portfolio through migrations and SKU rationalisation, while also investing in brand initiatives in tobacco, e-vapour and other consumer adjacencies.

Investments in markets and behind the MRM will further support quality growth… And our cost optimisation programme and enhanced capital discipline will fund the step change in investment.

Our FY17 priorities are on track and we will build on the success of the first half to support more quality growth in the balance of 2017 and beyond.

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Half Year Results 2017

Thank you. That concludes today's presentation and we'll now take any questions you may have.

The presentation is being webcast so please wait for a microphone and give your name and organisation before asking your question. May I have your first question…?